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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

FEDERAL POWER COMMISSION, *ET AL.*,
Petitioners,

v.

TEXACO INC., *ET AL.*,
Respondents.

On Writs of Certiorari
To The United States Court of Appeals
for the District of Columbia Circuit

BRIEF FOR THE RESPONDENT, PHILLIPS PETROLEUM COMPANY

Phillips Petroleum Company ("Phillips"), a Respondent before this Court and a Petitioner below, files this brief in response to briefs of the Solicitor General on behalf of the Federal Power Commission ("Commission"), Dudley T. Dougherty, *et al.*, Co-Executors of the Estate of Mrs. James R. Dougherty, *et al.* ("Dougherty"), the Independent Petroleum Association of America ("IPAA"), and the Small Producers Group.

Phillips accepts the statements in the brief of the Commission with respect to the Opinion Below, Jurisdiction, and Statutes Involved.

QUESTIONS PRESENTED

1. Can the Commission lawfully avoid its statutory duty to see that all rates are just and reasonable?

2. Can the Commission lawfully abridge its procedures for small producers if the result is to deny effective protection to consumers?

3. Can the Commission lawfully shift the burden of regulation and the burden of regulating to large producers and pipelines?

4. Can the Commission issue an order which unfairly discriminates in favor of small producers and pipelines and against larger producer plant owners?

STATEMENT OF THE CASE

A. BACKGROUND

1. In 1954 this Court held, in *Phillips Petroleum Company* v. *Wisconsin,* 347 U.S. 672,[1] that the Natural Gas Act ("Act") *requires* the Federal Power Commission to regulate wellhead sales for resale of natural gas in interstate commerce. For six years the Commission had staunchly sought to avoid this regulatory burden. The Court found, however, that

> "* * * the legislative history indicates a congressional intent to give the Commission jurisdiction over the rates of all wholesales of natural gas in interstate commerce. . . ."[2]

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[1] Hereinafter referred to as the "first Phillips" case.

[2] 347 U.S. at 682; emphasis added.

In response, the Commission set up procedures for producers to file their contracts with the Commission, to apply for certificate authority to make sales, and to effectuate contractually authorized rate increases. Perhaps more importantly, it initiated a rate case[3] in which it developed the basic methodology for determining just and reasonable producer rates under Sections 4 and 5 of the Act. Using this methodology, the Commission determined that the producer rates of Phillips were not unjust or unreasonable.[4]

From its experience in that initial producer rate case, the Commission concluded that an individual company approach to producer rate regulation was impractical, and, accordingly, it initiated its so-called "area rate proceedings" in which just and reasonable rates would be fixed for all jurisdictional producer sales in particular geographic areas.[5] In the first such area rate case to reach Commission resolution, the methodology which had been developed was again utilized under Sections 4 and 5, but this time to set just and reasonable rates for all jurisdictional producer sales made in the Permian Basin area of Texas and New Mexico.[6] This Court affirmed the Commission's area rate methodology and its application in the 1968 *Permian* case.[7]

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[3]Phillips Petroleum Company, Docket Nos. G-1148, et al.

[4]Phillips Petroleum Co., 24 FPC 537 (1960), aff'd sub nom., Wisconsin v. Federal Power Commission, 373 U.S. 294 (1963). This latter decision is hereafter referred to as the "second Phillips" case.

[5]In the second Phillips case, in addition to upholding the commission with respect to the producer rates in question, this court also upheld the Commission's conclusions as to the need for the area rate approach for subsequent producer rate determinations.

[6]Area Rate Proceeding (Permian Basin Area), Opinion No. 468, 34 FPC 159 (1965), aff'd sub nom., Permian Basin Area Rate Cases, 390 U.S. 747 (1968).

[7]Permian Basin Area Rate Cases, supra.

Since issuing its *Permian* order on August 5, 1965, the Commission has determined just and reasonable area ceiling rates for almost all major producing areas in the country.[8]

2. Subsequent to the Commission's *Permian* order there have been significant procedural developments which have considerably reduced the time required by the Commission for determining just and reasonable area rates. For example, in the first *Permian* case, the record was made between July 17, 1961 and September 10, 1963; there were over 200 hearing days and 30,000 pages of transcript; the initial decision was issued on September 17, 1964; and the Commission's Opinion

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[8] Area Rate Proceeding (Southern Louisiana Area), Opinion No. 546, 40 FPC 530 (1968), affirmed, Southern Louisiana Area Rate Cases, 428 F.2d 407; on rehearing, 444 F.2d 125 (5th Cir. 1970), certiorari denied, 400 U.S. 950; Area Rate Proceeding, et al. (Hugoton-Anadarko Area), Opinion No. 586, 44 FPC 761 (1970), affirmed, 466 F.2d 974 (9th Cir. 1972); Area Rates for the Appalachian and Illinois Basin Areas, Order No. 411, 44 FPC 1112 (1970); Area Rate Proceeding, et al. (Texas Gulf Coast Area), Opinion No. 595, 45 FPC 674 (1971), reversed, Public Service Commission for the State of New York v. Federal Power Commission, D.C. Cir., No. 71-1828, August 24, 1973, pending on petitions for certiorari in Nos. 73-966, et al.; Area Rate Proceeding, et al. (Southern Louisiana Area), Opinion No. 598, 46 FPC 86 (1971), affirmed, Placid Oil Company v. Federal Power Commission, 483 F.2d 880 (5th Cir. 1973), pending on petitions for certiorari, Nos. 73-437, et al.; Area Rate Proceeding, et al. (Other Southwest Area), Opinion No. 607, 46 FPC 900 (1972), affirmed, Shell Oil Company v. Federal Power Commission, 484 F.2d 469 (5th Cir. 1973), pending on petition for certiorari, No. 73-438; Area Rates for the Rocky Mountain Area, Opinion No. 658, April 11, 1973, appeal pending, Exxon Corporation, U.S.A. v. Federal Power Commission, D.C. Cir. No. 73-1854; Area Rate Proceeding (Permian Basin Area II), Opinion 662, August 7, 1973, appeal pending, Chevron Oil Company v. Federal Power Commission, 9th Cir., No. 73-2861.

468 was issued on August 5, 1965. In the second *Permian* case,[9] the hearing record was made between July 17, 1971 and January 11, 1972; there were only five hearing days and less than 1300 pages of transcript; the record from a slightly earlier area rate proceeding was incorporated by reference; the initial decision was issued on December 20, 1972; and the Commission's Opinion 662 was issued on August 7, 1973.

In addition, the Commission has asserted the right to set just and reasonable area ceiling rates by informal rulemaking.[10] Using this rulemaking procedure the Commission has issued one set of area ceiling rates which is now final[11] and another set[12]

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[9]Area Rate Proceeding (Permian Basin Area II), Opinion No. 662, appeal pending, Chevron Oil Company v. Federal Power Commission, 9th Cir. No., 73-2861.

[10]The appropriateness of this technique has been affirmed by the Ninth Circuit, Phillips Petroleum Company v. Federal Power Commission, 475 F.2d 842 (1973), although the D.C. Circuit has rejected it, Mobil Oil Corporation v. Federal Power Commission, 483 F.2d 1238 (1973). Petitions for certiorari addressed to the Ninth Circuit are pending in Chevron Oil Company, et al. v. Federal Power Commission, Nos. 73-91. The relevance of the rulemaking procedure to the instant cases is discussed at pages 00-00, below.

[11]Area Rates for the Appalachian and Illinois Basin Areas, Order Nos. 411, 44 FPC 1112 (1970).

[12]Area Rates for the Rocky Mountain Area, Docket No. R-425, Opinion No. 658, issued April 11, 1973.

which is now before the D.C. Circuit.[13] It also has decided to use this rulemaking procedure to set nationwide ceiling rates;[14] and this nationwide ratemaking technique, if upheld, would eliminate the need for periodic rate determinations for the several geographic areas previously involved in area-rate proceedings, thus cutting the time to minimum dimensions. Further, the Commission has established the "Optional Certificate Procedure" whereby it is undertaking to make both a certificate determination and a prospective just and reasonable rate determination in a single, unified proceeding.[15] Such proceedings

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[13] Exxon Corporation, U.S.A. v. Federal Power Commission, No. 73-1854.

[14] Just and Reasonable National Rates for Future Sales of Natural Gas from Wells commenced on or after January 1, 1973, Docket No. R-389-B, Notice issued April 11, 1973 38F.R. 10,014 (April 23, 1973); Nationawide Rulemaking to Establish Just and Reasonable Rates for Natural Gas Produced from Wells commenced before January 1, 1973, Docket No. R-478, Notice issued May 23, 1973 38F.R. 14,295 (May 31, 1973).

[15] Optional Procedure for Certificating New Producer Sales of Natural Gas, Order No. 455, 48 FPC 218, appeal pending, Moss v. Federal Power Commission, D.C. Circuit No. 72-1837.

now appear to be routine, and the time consumed appears to be about 6 to 8 months.[16]

Thus the Commission has adopted many new procedures for determining just and reasonable producer rates, procedures which are being used more and more frequently and which require less and less time.

On top of this picture should be superimposed the Commission's treatment of small producers, including the orders under review.

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[16]More than 70 applications for optional certificates have been filed since August of 1972. The Commission has issued favorable opinion in two cases, Belco Petroleum Corporation, et al., Opinion No. 659, issued May 30, 1973, and Felmont Oil Corporation, Opinion No. 676, issued November 30, 1973, while issuing one opinion denying an application to Corbin J. Robertson in Northern Michigan Exploration Company, Opinion No. 668, issued October 23, 1973.

In addition, at least seven initial decisions by administrative law judges have been issued, five approving and two denying applications. And at least four applications have been approved by the Commission pursuant to its shortened procedure for uncontested cases, 18 C.F.R. Subchapter A, Part 1, § 1.32 (1973). At least seven more cases are presently set for hearing.

The time consumed in reaching final decisions in these cases appears to range from five and one-half months (Pennzoil Producing Company, Docket No. CI72-321, application filed April 27, 1973, order issued October 12, 1973) to eight months (Felmont Oil Corporation, Opinion No. 676, supra, application filed March 28, 1973, order issued November 30, 1973, and Getty Oil Company, Docket No. CI73-593, application filed March 8, 1973, order issued October 25, 1973).

3. As we mentioned above, the Commission issued its producer regulations shortly after the first *Phillips* case.[17] Even then, the Commission was aware of the difficulties that might be presented by having to regulate many small producers; but it felt compelled by *Phillips* to reject any treatment of small producers that might amount to an exemption from regulation:

> "5. Some of the petitions urged that the regulations be amended to relieve small producers from the requirements of the statute. The Act does not provide for exemptions from its requirements . . ."[18]

The Commission, however, did recognize that small producers might be heavily burdened if they had to comply with all the procedural requirements imposed on large producers. And so as part of Order 174-B it did relieve small producers of some of those procedural requirements. For example, a producer with annual sales of less than 1,000,000 Mcf was required to file only five copies of his certificate application instead of fourteen; could use a simplified form provided by the Commission; and did not have to include copies of his contract. In addition, a very small producer, one with annual sales of less than 100,000 Mcf, did not have to file his contracts with the Commission as rate schedules, but could instead submit summaries showing only the approximate annual volume being sold, the rate charged, the purchaser, and delivery point. Also of significance was the regulation allowing all interest owners to be covered by the certificate and rate filings of the lease operator; this rule eliminated the need for every single one of the sellers to make a complete set of filings.[19]

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[17] Order No. 174-B, 13 FPC 1576 (1954).

[18] Id. at 1577.

[19] Id. at 1579-84, 1588

As might be expected, the Commission acquired additional experience regulating small producers during the next decade. Primary within that body of experience was the testimony adduced in the original *Permian* hearing on the basis of which additional regulatory short cuts were adopted for small producers. As we have already mentioned, the *Permian* record was made over a period of almost 26 months and was comprised of over 30,000 pages of transcript. Some of the evidence was introduced on the problems of the small producer, with emphasis on his difficulties in complying with the Commission's administrative requirements. There was also evidence as to the impact of small producer activities on supplies of interstate gas and, most importantly, the impact of small producer rates upon ultimate consumers (390 U.S. at 784-87).

Based on the evidence of record, the Commission in its *Permian* decision made findings of fact which established the basis for its treatment of the class. On this basis it concluded that the defining feature of the class should be annual sales of 10,000,000 Mcf or less, that certain abridged procedures would be appropriate for small producers, and that certain special pricing provisions would also be in order.[20] This Court relied on the Commission's findings of fact in its review and approval of the *Permian* decision (390 U.S. at 784-86):

> "The Commission reasoned that, in these circumstances, carefully selected special arrangements for small producers would not improperly increase consumer prices. Moreover, it concluded that such exemptions might usefully both streamline the administrative process and strengthen the small producers' financial position. The Commission provided two forms of special relief: first, it released small producers from the requirement that quality adjustments be made in price; and second, it commenced a rulemaking proceeding intended to relieve them from

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[20] 34 FPC at 235-36.

various filing and reporting obligations. See 34 FPC 434. The Commission asserted that the consequences for consumer prices of the first would be de minimus; it expected that the second would measurably reduce the small producers' regulatory expenses."[21]

It is important to note that the small producer rules thus adopted and approved in *Permian* did not encompass abandonment of the statutory just and reasonable standard. On the contrary, producer sales in the Permian area, including small producer sales, were to be made at rates no higher than the applicable just and reasonable area rate.[22] Thus, a small producer could initiate new sales at or below the area rate under a blanket certificate without prior Commission review,[23] and it could avoid all rate filings but only so long as its rate did not exceed the area rate ceiling.[24] Moreover, the Commission declined to apply its streamlined *Permian* procedures to small producer sales in other areas until just and reasonable area rates could be established for application to such sales (and other producer sales).[25] And it specified that small producers, in the annual statements which they were required to file, certify that the volumes of gas sold during the year were sold at or below the just and reasonable rate fixed by the Commission.[26]

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[21] 390 U.S. at 786, footnotes omitted. The full text of the rules is reported at 34 FPC 434 (1965).

[22] 34 FPC at 231, 235-36. See also, El Paso Natural Gas Co., et al., 35 FPC 40 (1966).

[23] 34 FPC at 235. To the same effect see also the orders issued in the related rulemaking docket: Notice of Proposed Rulemaking, Docket No. R-279, 34 FPC 434 (1965); Order No. 308, 34 FPC 1202 (1965).

[24] 34 FPC at 236.

[25] 34 FPC at 235.

[26] Id. at 236.

Thus an examination of the principal differences between the small producer regulations promulgated in Order 174-B and those based on *Permian* shows an evolution that was essentially definitional and procedural: (1) the definition of "small producer" was made uniform and was expanded to cover all producers with annual sales of 10,000,000 Mcf or less; (2) the blanket certificate was introduced so that a new application with its attendant delay was not necessary every time a small producer wanted to start a new sale; (3) the blanket certificate would carry with it exemption from the requirement to file contracts as individual rate schedules and the requirement to file rate increase notices *so long as* the rates were at or below the just and reasonable area ceiling rates; and (4) each small producer was required to file only a single, simplified statement each year showing that the small producer's sales were at or below the 10,000,000 Mcf level and were being made at or below the just and reasonable area ceiling rates.

Thus the new *Permian*-based regulations were tied inextricably to implementation of the just and reasonable rate standard.

For example, as soon as it promulgated just and reasonable rates for other areas, the Commission correspondingly extended the availability of its small producer procedures.[27] And when the *Permian* moratorium on above-ceiling rate increases lapsed, small producers were allowed to increase their rates above the just and reasonable ceiling, but only if they filed the standard notice required by Section 4 of the Natural Gas Act. This left

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[27] Area Rate Proceeding (Southern Louisiana Area), Opinion No. 546, 40 FPC 530, 612-14 (1968), affirmed, Austral Oil Co. v. Federal Power Commission, 428 F.2d 407, affirmed on rehearing, 444 F.2d 125 (5th Cir. 1970); Area Rate Proceeding, et al. (Hugoton-Anadarko Area), Opinion No. 586, 44 FPC 761, 781 789-90 (1970); Area Rates for the Appalachian and Illinois Basin Areas, Order No. 411, 44 FPC 1112, 1131-32 (1970).

them with the same suspension and refund exposure as any other producer.[28]

Thus, until the orders under review were issued, the parameters were clear: relief from burdensome filing requirements to the extent that the small producer stayed within the just and reasonable area ceiling rates.

B. PROCEEDINGS BEFORE THE COMMISSION

When the Commission initiated the instant proceeding, the notice made it quite clear that the Commission was prepared to go much further than it ever had before. Not only was the Commission proposing to further simplify filing requirements for small producers, but it was even proposing "* * * to exempt from regulation under the Natural Gas Act all existing and all future jurisdictional sales made by small producers * * *" (App. 1). Further examination of the notice discloses that the only limits the Commission proposed on the exemption would be a requirement to file an annual statement setting forth the small producer's total jurisdictional sales and a *caveat* that, if a small producer should ever exceed the 10,000,000 Mcf annual limitation, sales initiated thereafter would be fully subject to regulation although his existing sales would remain exempt (App. 2-3). Gone was the *Permian* requirement that the annual statement verify that all of the small producer's sales were made at or below the just and reasonable area rates.

The proposed mechanism for extending the small producer exemption included (1) broadening of the blanket certificate's effectiveness so that it would allow the initiation of sales, without a certificate application, anywhere in the country rather than just in those areas where just and reasonable area

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[28] Area Rates for Small Producers (Permian Basin Area)—Increased Rate Filings, Order No. 394, 43 FPC 16 (1970). See also the Notice issued in Docket No. R-374 on November 4, 1969 for an additional discussion of the Commission's views (34 F. Reg. 18180 (November 13, 1969)).

ceiling rates have been set; (2) freedom to make both existing and new sales of gas at the contract rate without being restricted to the just and reasonable area ceiling rates; and (3) an annual statement listing the total volume of all sales and, separately, the area, purchaser, volume, and price of each sale.

Recognizing also that the increased costs resulting from the exemption would have to be absorbed by someone, the Commission indicated that pipeline purchasers would be able in turn to track such resulting rate increases through their rates (App.3), but it proposed that a large producer's resale of gas purchased from a small producer would remain subject to Commission jurisdiction (App. 2-3). Apparently realizing that such discriminatory treatment of large producers might not sit too well with large producers, the Commission added, "* * * If there are any problems in this regard, large producers in their comments should discuss these problems" (App. 4).

Comments were filed by a number of parties (App. 14-96), including Phillips (App. 22-31). A conference was also held (App. 97-134). In its comments, Phillips urged, *inter alia*, that the Commission has no authority to create the proposed exemption (App. 30) and that the proposed regulations would discriminate unfairly against Phillips (App. 25-30). Phillips purchases and processes significant quantities of gas from small producers for the extraction of natural gas liquids. If Phillips were restricted to the just and reasonable area ceiling rates for the resale of residue gas, it would become unable to purchase any new gas at all from small producers or else would have to pay more for such gas than it could possibly collect for its resale (App. 26). This economic restraint imposed on large producers was contrasted with the freedom the Commission proposed to allow pipelines which, for example, would be able to purchase gas from a small producer at above-ceiling prices *plus* the value of extracted liquids, all the while being able to pass all these costs along to the consumer through the proposed tracking authority (App. 27-28). Phillips specifically suggested that it be allowed to supplement its existing rate schedules to pass through above-ceiling rates to its pipeline purchasers (App. 28).

When the Commission issued its Order No. 428 (App. 135-154), it prescribed regulations applying directly to small producers which were substantially the same as proposed. Thus the effectiveness of the blanket certificate was extended to all areas of the country, even if just and reasonable area ceiling rates had not been established (App. 149); sales would be made at the contract rates irrespective of the just and reasonable area ceiling rates (App. 149); and an annual statement was prescribed without a provision assuring that all sales had been made at or below just and reasonable rates (Order No. 428-A, App. 161). Additionally, certain minor limitations were imposed.[29]

The Commission then went on, however, to deal with the objections and problems raised generally by the large producers and pipelines who buy from small producers. In response to objections that the Natural Gas Act does not allow for exemptions and that the proposed regulations would create unfair discrimination, it stated that the small producer rules it was issuing *would* amount to regulation (App. 137), because such regulation would be conducted at the pipeline level through the review of the purchased gas costs of each pipeline with respect to new small producer purchases. Although small producers would not be subjected to refund liability, the pipelines' rates related to *new* small producer sales would be subject to reduction and refund according to a new tracking test, *i.e.* "* * * as to that part of the rate which is unreasonably high considering appropriate comparisons with highest contract prices for sales by large producers or the prevailing market price for intrastate sales in the same producing area * * *" (App. 142).

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[29]A small producer could not abandon his sale without authorization under Section 7(b) of the Act. (App. 149). Certain indefinite pricing provisions could not be used to escalate prices above the area ceiling (App. 149-150). The exemptions would not apply to the sale of developed reserved purchased from a large producer (App. 149) and should a contract expire, the small producer could not collect anything above the highest contract rate without making a filing under Section 4 of the Act (App. 141, n.4).

Cost increases resulting under *existing* small producer sales were permitted to be passed on by pipelines without Commission review (App. 246 n. 5).

This same tracking test was also imposed on large producers, but the Commission tacked on two further requirements: (1) for the large producer to pass on such above-ceiling small producer rates, the higher rate must be contractually authorized and (2) the price differential between the purchase and resale prices must not exceed the prevailing price differential in the area (App. 150). Furthermore it would appear that these additional tests were prescribed for both existing and new small producer sales.

Eleven parties filed applications for rehearing (App. 155-158; 162-237), including Phillips (App. 221-30; as amended, App. 231-37). Phillips objected that the scheme of indirect regulation imposed by Order 428 was not fairly covered by the notice (App. 222-23), that the Commission has no authority to make exemptions like this (App. 223-25), and that the order unfairly discriminates against Phillips in a number of ways (App. 225-29); a vivid example of a pipeline's newly enhanced power to outbid Phillips for new small producer gas—an incident which occurred less than 30 days after issuance of order 428 but even before its effective date—was submitted to the Commission in an amendment to Phillips' application for rehearing (App. 231-37).

In Order No. 428-B, the Commission responded to the various applications for rehearing. Specifically with respect to complaints by large producers, the Commission allowed a large producer to resell gas newly purchased from a small producer at a higher rate designed to maintain the existing price differential, but only (1) *if* it is able to negotiate a new resale contract with the pipeline purchaser, (2) *after* it has filed a certificate application to cover such new contract, and (3) *subject* to refund down to whatever rate level is finally approved by the

Commission (App. 241, 253).[30] In most other respects, the Commission declined to make any significant changes in its small producer rules.

C. THE DECISION BELOW

On petitions for review, the United States Court of Appeals for the District of Columbia Circuit set aside Orders 428, 428-A, and 428-B. The Court began by reviewing the Commission's goals and stated that it was not challenging either the Commission's motives or its opinion that some form of deregulation of small producers might benefit the consumers of natural gas (Pet. App. 5a). Nowhere did the Court object to the Commission's extending the effectiveness of the blanket certificate to all areas of the country or the omission of Section 4 rate filings as long as the rates meet the just and reasonable standard.

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[30] Perhaps the most striking example of the discrimination against large producers was the Commission's refusal to permit them to pass on small producer increases up to the Commission-prescribed area minimum rate. The orders allow small producers to collect the minimum rate even if it is not authorized by their contracts, but large producers cannot pass these increases on. The Commission held, in effect, that although the public interest required the small producer-large producer contract to be set aside so as to permit such an increased small producer rate, nevertheless the same public interest would not permit the large producer-pipeline resale contract to be set aside to permit the flow through of that small producer increase to the pipeline and the public (App. 240-241). Ironically, the Commission relied on this Court's opinion in Federal Power Commission v. Sierra Pacific Power Co., 350 U.S. 348 (1956), to support both actions (App. 144, 240-241). The minimum price powers in area rate proceedings are exercised on the authority of Sierra; see, *e.g.*, Permian, supra, 34 FPC at 231-32.).

The Court's fundamental objection, however, was that:

"* * * The Commission may not ignore the command of Section 4 (15 U.S.C. §717(c) (a)):

> '*All* rates and charges made, demanded, or received by *any* natural-gas company for or in connection with the . . . sale of natural gas subject to the jurisdiction of the Commission . . . shall be just and reasonable, and *any* such rate or charge that is not just and reasonable is hereby declared to be unlawful.* * *'

"The Commission must also heed similar language in Section 5 (15 U.S.C. §717(d)):

> 'Whenever the Commission, after a hearing had upon . . . complaint of any State, municipality, State Commission, or gas distributing company, shall find that *any* rate, charge or classification demanded, observed, charged, or collected by *any* natural-gas company in connection with *any* . . . sale of natural gas, subject to the jurisdiction of the commission . . . is unjust, unreasonable, unduly discriminatory, or preferential, the Commission *shall* determine the just and reasonable rate, charge, classification . . . or contract to be thereafter observed and in force, and *shall* fix the same by order . . .' "[31]

In the Court's view, the Commission, if it were operating under these small producer rules, simply could not meet its obligations under the Act "* * * to assume 'jurisdiction over the rates of *all* wholesales of natural gas in interstate

[31] Pet. App. 7a-8a; emphasis by the Court; footnote omitted.

commerce' . . . to insure that all such rates comply with the statutory standard."[32] First, the Natural Gas Act does not allow for such exemptions, as does, for example, the National Labor Relations Act (Pet. App. 8a-9a). Second, the Commission's power to classify persons subject to its jurisdiction cannot be used to exempt indirectly when the Commission could not exempt directly; further the power to classify and to issue rules and regulations can only be used to carry out the Commission's obligations under the Act, not to avoid them (Pet. App. 9a-10a). Third, the Court completely rejected the indirect regulation of small producer prices as urged by the Commission because the "unreasonably high" standard is simply not the equivalent of "just and reasonable" and is tied to factors which the Commission does not and cannot regulate (Pet. App. 11a-13a). In conclusion the Court said, " * * * we cannot hold that *non*regulation is the statutory equivalent of regulation * * *"[33]

Judge Fahy dissented, stating his belief that the Commission was engaged in an experiment to see whether a higher rate than that previously fixed for the industry in the area may be just and reasonable for the small producer as a separate classification within the area (Pet. App. 20a). It appears (although we are not certain) that Judge Fahy would avoid disturbing the orders until the Commission had concluded review of its experiment (Pet. App. 20a-21a). He did, however, recognize that large producers and pipelines are themselves consumers; and so he would strike those provisions of the order absolving small producers from any refund obligation even for those rates which the Commission eventually finds to be unreasonably high (Pet. App. 22a).

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[32]Pet. App. 8a; emphasis by the Court. The Court of Appeals also added (Pet. App. 8a):

> "[10] The Supreme Court has described 'the Fixing of "just and reasonable" rates' as 'the heart of the new regulatory system.' *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 611 (1944)."

[33]Pet. App. 16a; emphasis added by the Court.

SUMMARY OF ARGUMENT

It should be recognized from the start that Phillips does not challenge the Commission's power to separately classify small producers and prescribe special treatment for them. But the Commission has not seen fit to do just that. Instead it has totally exempted them from the just and reasonable standard of the Act. In doing so it has simply gone too far. It has no authority to so exempt. It has precluded effective consumer protection. It has placed the burden of regulation on the wrong parties. And it has unfairly discriminated against large producers. The orders therefore must fall.

First, the orders do *exempt* all small producer rates from the just and reasonable and initial certification standards required by the Natural Gas Act. The Commission has no authority to exempt such sales from the standards of the Act because under Commission and judicial precedent the standards of the Act are mandatory and allow for no Commission-created exceptions. The small producer regulations which have been approved in the past offer no valid precedent because the former regulations were procedural in nature and were always specifically restricted to situations where the small producers' rates were subject to the just and reasonable area ceiling rates.

Second, the "indirect regulation" which the Commission offers is not an adequate substitute for the direct regulation it has abandoned. The Commission's substitute standards assume prices in excess of just and reasonable rates. Moreover, nothing assures us that the Commission ever will scrutinize such above-ceiling rates. And, even if it should, there is no procedure for protecting the consumers against excessive rates until the Commission finally does get around to acting.

Third, the Commission's intention to review small producer rates through its review of resale rates of large producers and pipelines purchasing from small producers constitutes an illegal attempt to shift the burden of regulation from the small producers to large producers and pipelines. The Commission

has provided no definite standards and, as a result, such large producers and pipelines must act at their peril—gamble that the small producer rates will ultimately be viewed favorably by the Commission. Further, the Commission has attempted to make regulated companies do the job of regulators although Congress has directed that the Commission exercise this responsibility.

Fourth, the Commission has unduly discriminated against large producers, contrary to the Act and the Commission's Rules and Regulations, and in violation of constitutional requirements and standards. Undue preferences have also been accorded small producers and pipelines.

For all of these reasons, Phillips submits that the Court of Appeals correctly set these orders aside.

ARGUMENT

I.

THE COMMISSION HAS NO POWER TO EXEMPT JURISDICTIONAL SALES FROM THE REQUIREMENTS OF THE NATURAL GAS ACT

A. The Commission Has Exempted Small Producer Sales from Rate Regulation.

There should be no mistake about it. The Commission's orders go well beyond the small producer rules adopted in *Permian* and exempt small producer sales from rate regulation. Both the Commission's brief (page 13) and Dougherty's Brief (page 25) urge that, under the new small producer rules, small producer *rates* will be just and reasonable. The Commission's orders themselves, however, make it clear that the just and reasonable standard would never again be applied directly to the

rates charged by small producers themselves.[34] A small producer is free to charge whatever his contract calls for and "* * * the provisions of that contract will not be subject to change" (App. 249). Thus, even if the Commission should find a small producer rate improper for pass-through, the small producer would have no refund obligation and would not even have to reduce his rate prospectively to the level found proper by the Commission.[35] Further, it is simply a logical impossiblity that the same rate could at the same time be just and reasonable for a small producer but unjust and unreasonable for the large producer or pipeline which is merely selling the same gas and passing on the same rate.

The rate review which is precluded during the life of a small producer sale is also absent at its commencement, for under his blanket certificate a small producer can begin any sale as soon as the purchaser is able to start taking, without any necessity to await Commission scrutiny of the sale. Again, this procedure is radically different from the *Permian* small producer rules which permitted new sales to be initiated under the blanket certificate only if the rate did not exceed the just and

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[34]The regulations issued by the Commission quite specifically refer to the "exemption" therein authorized no less than 7 times on a single page and once to "* * * any small producer sale exempted hereunder * * *" (App. 149).

[35]It must have come as quite a shock to small producers to see Commission Counsel's claim that the Commission remains free to order prospective reduction of a small producer's rates under Section 5(a) of the Act (Brief, page 15). The justification relied upon would appear to be the Commission's cryptic promise in Order 428 to "take further action" if its "review" of new small producer rates establishes something "inimical to the interests of consumers" (App. 145). In view of the Commission's attempt to "assure" the small producer that his "contract will not be subject to change" (App. 249) and in view of the blanket certificate authorization to sell gas "at the price specified in each . . . contract" (App. 149), there is doubt that the Commission would be at all free to initiate a Section 5(a) proceeding against any small producer. Civil Aeronautics Board v. Delta Air Lines, Inc., 367 U.S. 316, 333-34 (1961); United States v. Seatrain Lines, Inc., 329 U.S. 424 (1947).

reasonable area rates.

B. The Natural Gas Act and Judicial Precedent Require that the Commission Regulate Small Producer Sales by the Statutory Standards.

The Natural Gas Act was adopted as a corrective measure. It was framed not to penalize certain proscribed acts, but to prevent their occurring at all. As a principal objective, Congress sought to prevent "natural-gas companies" [36] from charging excessive rates for jurisdictional sales of natural gas. So it proscribed such rates and instructed the Commission to regulate and determine rates under the just and reasonable standard of Sections 4 and 5.

Congress left no ambiguity in the statutory language establishing the Commission's obligation to review rates. Section 4(a) states that:

> "*All* rates and charges . . . for . . . the . . . sale of natural gas . . . shall be just and reasonable, and *any* such rate or charge that is not just and reasonable is hereby declared to be unlawful."[37]

Since the provision could not be self-executing, Congress established the forum and the procedure for Commission scrutiny of rates:

> "(c) * * * every natural-gas company shall file with the Commission . . . all rates and charges for any . . . sale * * *.

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[36]Section 2(6) of the Act defines a "natural-gas company" to be "a person engaged in . . . the sale of natural gas in interstate commerce . . . for resale" 52 Stat. 821(1938); 15 U.S.C. §717a.

[37]Natural Gas Act, Section 4(a), 52 Stat. 822 (1938), 15 U.S.C. §717c(a); emphasis added.

"(d) * * * no change shall be made by any natural-gas company in any such rate . . . except after thirty days' notice to the Commission and to the public * * *.

"(e) Whenever any such new [rate] . . . is filed the Commission shall have authority . . . to enter upon a hearing concerning the lawfulness of such rate . . . ; and, pending such hearing . . . the Commission . . . may suspend the operation of . . . such rate . . . but not for a longer period than five months * * * [T]he Commission may . . . upon completion of the hearing and decision . . . order such natural-gas company to refund, with interest, the portion of such increased rates or charges . . . found not justified."[38]

And this Court has spoken pointedly of the Commission's obligation, under these provisions of the Act, to, at least, review rates *before* they become effective:

"* * * the Act provides . . . for *notice* to the Commission of the rates established by natural gas companies and for *review* by the Commission of those rates.§ 4(d) means simply that *no* change—neither a unilateral change to an ex parte rate nor an agreed-upon change to a contract—can be made by a natural gas company without the proper notice to the Commission. * * *" 39

Section 5 of the Act requires, whenever any rates are found to be unjust and unreasonable, that the Commission thereupon determine just and reasonable rates. This section operates prospectively only since a rate proceeding thereunder

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[38]Natural Gas Act, Sections 4(c), 4(d), and 4(e), 52 Stat. 822 (1938), as amended 15 U.S.C. § §717c(a), 717c(e).

[39]United Gas Pipe Line Co. v. Mobile Gas Service Corp., 350 U.S. 332, 343 (1956).

is not initiated by a rate increase filing. Moreover, there is no power to suspend or prescribe refunds.

The Natural Gas Act, of course, contains two exceptions[40] and one exemption provision,[41] but they are strictly construed, *Interstate Natural Gas Co.* v. *Federal Power Commission*, 331 U.S. 682, 690-91 (1947); and no one has even suggested their relevance to this case.

As we have already mentioned, once this Court made it clear in the first *Phillips* case that producer *sales* are jurisdictional and not within the production and gathering exemption of Section 1(b), the Commission set about developing the regulatory technique for setting just and reasonable producer rates.

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[40]Section 1(b), 52 Stat. 821 (1938), 15 U.S.C. §717(b) provides:

> "(b) The provisions of this Act . . . shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

Section 1(c) 68 Stat. 36 (1954), 15 U.S.C. §717(c) provides:

> "(c) The provisions of this Act shall not apply to any person engaged in or legally authorized to engage in the transportation in interstate commerce or the sale in interstate commerce for resale, of natural gas received by such person from another person within or at the boundary of a State if all the natural gas so received is ultimately consumed within such State, or to any facilities used by such person for such transportation or sale, provided that the rates and service of such person and facilities be subject to regulation by a State commission. * * *"

[41]Section 7(c), 52 Stat. 825 (1938), as amended, 56 Stat. 83 (1942); 15 U.S.C. §717F(c) provides:

> "* * *the Commission . . . may by regulation exempt from the requirements of this section temporary acts or operations for which the issuance of a certificate will not be required in the public interest."

The entire course of this development was based on the requirement that *all* jurisdictional producer sales must be regulated under the mandatory statutory standard. Small producer sales were always included although small producers as a class admittedly received special treatment. Thus the Court's *Permian* decision can only be read as approving special treatment for small producers in a situation where their sales were subject to just and reasonable ceiling rates along with those of the large producers.[42] *Permian* did not approve an exemption from the just and reasonable standard of the Act. Rather it held that where compliance with that standard is provided for, the Commis-

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[42]The following excerpts from Opinion No. 468 demonstrate the Commission's considerations in issuing its small producer regulations in Permian. Despite a recommendation by the Examiner that all small producer rates be approved at their contract levels, the Commission insisted on the applicability of the just and reasonable standard to small producer sales (34 FPC 234-36; emphasis added):

> "In our opinion the salutary objectives of those who propose exemption can better be achieved *within the framework of regulation.* * * *
>
> "A basic consideration in reaching our conclusion in this matter is that the impact of the small producer prices on consumers is by no means *de minimis* on an area basis, and is of great impact in some situations. * * *While small producers represent only 15 percent of the aggregate interstate gas supply it is obvious *they are a substantial factor in the cost of the gas supply of millions of American consumers.*
>
> * * * * *
>
> "Sales in areas other than the Permian Basin by small producers will not be eligible for coverage by such certificates *until an area rate is fixed therein because the determination of a specific area rate is a prerequisite for the issuance of such certificates.*
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> * * * * *
>
> "* * *Of course, no increases above the applicable area ceiling will be permitted without the approval of the Commission pursuant to the filing requirements of Section 4(d). * * *"

sion may abridge certain of its procedures.[43]

Thus it is clear that there is no statutory or judicial basis for exempting small producers from the just and reasonable standard of the Act. Since *exemption* from that standard is precisely what the orders accomplish, they must be set aside.

II.

THE "INDIRECT REGULATION" PROVIDED BY THE COMMISSION DOES NOT EFFECTIVELY PROTECT THE CONSUMER

Since the orders preclude the regulation of small producer rates, the Commission seeks to save its orders by promising us "indirect" regulation. Like so many labels, however, this one only diverts our attention from what really lies underneath. The Commission has voluntarily relinquished so many of its regulatory tools that with those which remain the Commission cannot fulfill the role prescribed by Congress. The remaining regulatory skeleton does not adequately protect consumers as the Act requires. We believe that the Court of Appeals correctly

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[43]The Commission's brief suggests (page 4) that statements by Mr. Justice Clark in dissent (Wisconsin v. Federal Power Commission, 373 U.S. 294, 329-30) and for the Court (Federal Power Commission v. Hunt, 376 U.S. 515, 527) lend support to the Commission's assertion of authority to exempt small producers as part of its efforts to regulate producer sales. The cited language, however, goes no further than recommending to the Commission a study to determine whether certain exemption procedures available to other agencies under other statutes might also be appropriate for the Commission. There was no hint at all that this Court had itself made such a study and even less than it was holding such exemption procedures to be available under the existing statutory language. See also the Court of Appeals' discussion of this area, Pet. App. 8a-9a.

assessed such indirect regulation when it said (Pet. App. 12a-13a).

> "* * * At best, the indirect controls it has proposed will insure that the small producer rates which are passed on to consumers are below levels set by private contracting parties (or . . . by state regulation . . .). Nothing at all insures that those levels will be 'just' or 'reasonable'. That is the essential flaw in the Commission's plan. That is the point at which the FPC abdicates its regulatory responsibility in derogation of the purposes and mandatory terms of the statue. Indirect 'regulation' by such novel 'standards' is worse than an exemption simpliciter. Such an approach retains the false illusion that a government agency is keeping watch over rates . . . when it is in fact doing no such thing."

As we established in the preceeding section, the regulations do in fact exempt small producers from rate regulation. The indirect regulation argument is therefore an *impact argument*, namely, that the impact on the consumers will not be all that bad, and that, in reality, they will get all the protection that the Act requires. An analysis of the impact of the putative indirect regulation shows, however, that the Court of Appeals was correct in its assessment.

For some unexplained reason the Commission's brief (page 20) states that the issue of indirect regulation was not reached by the Court of Appeals because the Court thought the orders provide for *non*regulation rather than indirect regulation. The Court, however, did consider the indirect regulation argument in Section "B" of Part II (Pet. App. 10a-16a) and rejected the argument *because* such indirect regulation amounts to nonregulation.

Initially the Court noted that a type of indirect regulation might be acceptable which provides that small producer rates could be passed on only if such rates themselves were just and reasonable. But the Commission has not done this; and, even if it did, the Court noted that there still might be some valid

objection due to unfair prejudice against the large producer and pipeline purchasers.[44]

The Commission's proposed standard would prohibit pass-through of new small producer rates if they are:

> "* * * unreasonably high considering appropriate comparisons with highest contract prices for sales by large producers or the prevailing market price for intrastate sales in the same producing area.* * *"[45]

This standard has no relation to the "just and reasonable" standard. Large producers can and do contract to sell interstate gas at prices which exceed the area rates and which in fact have no inherent relation to the just and reasonable rates fixed by the Commission. Likewise, rates for intrastate sales are traditionally higher than the Commission's area rates for interstate sales. The orders proscribe pass-through of small producer rates only if they are "unreasonably high" when compared with rates which are themselves unjust and unreasonable. This is not regulation by the just and reasonable standard. Rather such a standard dismisses as irrelevant all the just and reasonable determinations the Commission *has* made. As the Court of Appeals correctly characterized it (Pet. App. 16a), this amounts to *non*-regulation.

In a different section of its brief the Commission does attempt to rehabilitate its indirect regulation argument. It contends (Brief, pages 16-18) that the Court of Appeals misread the orders as saying that the only standards are the highest large producer contract prices or the prevailing intrastate price when the Commission itself said (App. 142) that these are only two factors and that the Commission will consider all relevant factors. But the promise is hollow.

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[44]Pet. App. 10a-11a, n. 17.

[45]App. 142.

What else will the Commission consider? The Commission's brief explains it this way (pages 17-18; emphasis in the original):

> "The order was thus designed to put producers and pipelines on notice that in the context of small producer rate increases, the field prices *would* be considered along with the traditional elements of a rate-base formula. * * *"

Thus it would appear from argument of counsel that small producer costs will also be considered. But how wide is the range of reasonableness within which the Commission must determine just and reasonable rates? And *how* is the Commission ever going to determine what a given small producer's costs are when it has determined not to impose the burden of such proceedings on small producers? On the other hand, if the Commission is going to determine small producer costs, why can it not make a specific determination of just and reasonable rates for small producers? The order itself indicates that the argument of counsel lacks merit. For example in contradistinction to any idea of "traditional elements of a rate base formula" is the Commission's language from Order 428-B (App. 246):

> "* * * The standard * * * provides pipelines with a more concrete guide for their future actions than would exist in the absence thereof. Simply put, the Commission wanted the pipelines to know in advance the boundaries within which they could freely contract with small producers."

The language is obviously designed to reassure the pipelines that if they do not exceed the two enunciated non-statutory standards, if they stay within the "boundaries," they do not have to worry about any other "relevant factors," *i.e.*, they can "freely contract with small producers." As the Court below observed, "* * * It strains credulity to assert that the Commission meant to achieve just and reasonable rates through normal market forces, while in the very same orders it refused to let pipelines and large producer plant operators pass on these 'just and reasonable' rates without further review under new non-

statutory standards" (Pet. App. 14a).

The lack of clarity in the announced Commission standards is indicative of the absence of genuine regulation.

Even more indicative is that the announced standards apply *only* to *new* contracts. There are no standards at all to be applied to contracts entered into before Order 428.[46] Thus some of the very same contracts which were found unjust and unreasonable by the area rate orders issued before Order 428 are now freed from that determintion. What could not be charged before Order 428 can now be passed on to the consumer without any reduction or refund exposure. This is not regulation, nor even *non*regulation. It is complete abdication. It can hardly pretend to meet the statutory just and reasonable standard.

The Commission, by allowing the initiation of *new* sales at above-ceiling rates under blanket certificates, has also set aside another instrument of regulation. Under the *Permian* small producer regulations, as we have mentioned, a small producer could initiate new sales without the scrutiny that accompanies a certificate application but only as long as his rates were within the just and reasonable ceiling rates set by the Commission. Under the new regulations, however, new sales can be initiated anywhere, at any rate, without any Commission scrutiny.

This must be contrasted with the caution that was enjoined upon the Commission in the CATCO decision where this Court required the Commission to give "most careful scrutiny and responsible reaction" to initial rates of producers and, where necessary, to reduce those rates by certificate condition so "that the consuming public may be protected while the justness and reasonableness of the price fixed by the parties is being determined under other sections of the act."[47]

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[46] App. 246, n. 5.

[47] Atlantic Refining Co. v. Public Service Commission of New York, 360 U.S. 378, 392 (1959).

Perhaps in awareness of this responsibility, the Commission said it would review the rates for new small producer sales in certificate or rate proceedings involving the pipeline. Thus, it explained (App. 139):

> "* * * Any question as to the propriety of the price paid by a pipeline to a small producer will be subject to review in certificate and rate cases involving that pipeline to make sure it is justified. The Commission has ample authority to inquire in these cases into the reasonableness of all items of operating expense, including the cost of purchased gas, and to disallow items of cost which are imprudent. * * *"[48]

As to such review in pipeline *certificate* cases, the Commission well knows that in most situations new supplies of gas are connected by pipelines under annual blanket budget-type *facility* certificates.[49] The pipeline is not required to obtain a certificate for the *purchase* of gas, but only for the construction of jurisdictional facilities necessary for such purchase (Section 7). Routine, minor connecting facilities necessary to pick up a new package of small producer gas normally would be built by a pipeline under a pre-granted budget-type certificate since no new pipeline sale would be involved, and the Regulations merely require pieplines to report constructed budget-type facilities "within sixty days after expiration of the authorized [12-month] construction period."[50] Furthermore, review of the small producer *rate* in the pipeline's *facility* certificate docket may be improper, and any Commission action would be prospective at best.

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[48]See also the Commission's elaboration of this point in Order No. 428-B (App. 245).

[49]Regulations under the Natural Gas Act §157.7(b), 18 C.F.R. Ch. I, Subchapter E, §157.7(b).

[50]Regulations, §157.7(b)(3), 18 C.F.R. Ch. I, Subchapter E, §157.7(b)(3).

This is hardly the equivalent of the regulation required by Section 7 of the Natural Gas Act. Even if the Commission should at a later date determine to take a closer look at some of the rates initiated under the blanket certificate, it still can do no more than "regulate" "indirectly" under the ephemeral standards we have already examined and could act only prospectively. The Commission thus would be playing catch-up at best. This too marks a decided shortfall from the regulatory standard.

In view then of the manifold deficiencies presented by these orders, it can only be said that the Commission's promise of indirect regulation amounts to a promise, maybe, to regulate someone, some day, under some standard, if the Commission feels like it. Such indirect regulation is a mockery of the active, continuous, all-encompassing regulatory scrutiny *mandated* by the Act. It requires that the orders be set aside.

III.

THE ORDERS ILLEGALLY SHIFT THE BURDEN OF REGULATION AND THE BURDEN OF REGULATING TO LARGE PRODUCERS AND PIPELINES

It is quite clear, first, that the orders shift the burden of regulation from the small producers to their purchasers. The small producers will be free to collect revenues at the contract rate (App. 149) without any refund obligation (App. 142) while their large producer and pipeline purchasers' rates will be subject to reduction and refund according to the so-called "unreasonably high" standard (*ibid.*). Thus the purchaser would have to absorb the difference between the small producer's contract rate and whatever rate the Commission might find not unreasonably high. As we have already shown, large producers and pipelines are provided no definitive standards by which to determine whether the purchase price will be viewed favorably by the Commission, yet it is apparent that the Commission expects the large producers and pipelines at their peril to effectuate the purpose of the Commission's orders in their purchases from small producers.

Nothing in the Act authorizes the Commission to require one class of regulated companies to insulate another, preferred, class of regulated companies from the effects of regulation or to absorb the regulatory burden that should rightfully be imposed upon the preferred class. Any attempt to do so constitutes confiscation and denial of due process of the clearest kind. That the Commission even professes the intent to regulate by such indirection establishes the invalidity of the Commission's orders.

The Commission argues that its method merely applies the old rule that regulated companies may include in their cost of service only those costs which are reasonable (App. 245). But such an assertion ignores the mandate of Sections 4 and 5 of the Act that all rates charged must be just and reasonable. As consumers themselves, large producers and pipelines have a right to expect to pay only just and reasonable rates for the gas they buy. Moreover, the assertion ignores the refund provision of Section 4 which is the statutory means of assuring that *every* natural-gas company shall carry its own share of the regulatory burdens. Since the orders eliminate the small producers' obligation to make refunds of rates subsequently found to be unjust or unreasonable, they plainly impose very different risks on such regulated purchasers from those that previously existed.

The orders also erroneously shift the burden of *regulating* from the Commission to large producers and pipelines which purchase gas from small producers, for it is apparent that the Commission has abdicated *its* responsibility to fix rates for small producer sales in the public interest and has instead required the large producer and pipeline purchaser to do so through contract negotiations. Such a shift not only ignores the statute which imposes the regulating responsibility on the Commission, but it also places an impossible burden on such purchasers.

The large producer and pipeline purchasers are not regulators. They are, obviously, part of the regulated industry whose functions are to find, sell, transport, and deliver natural gas to purchasers for ultimate public consumption. And while such purchasers are enjoined by the Act from charging rates which are unjust and unreasonable, the Act requires the *Commission*

to determine whether or not such rates are just and reasonable and, if not, to prescribe rates which are. Unless and until Congress determines that all producer rates are to be established by market forces alone, this division of responsibilities clearly shows a Congressional conviction that the expertise to determine and fix such rates in the public interest is in the regulatory body.

The intent of Congress in this regard is understandable. For instance, when certain kinds of costs *are* to be passed on to consumers through the rates to be charged by a natural gas company, the standard of reasonableness is usually one of managerial prudence and discretion. On the other hand, there are major policy decisions in ratemaking which must, of their nature, be made by regulatory bodies—decisions where the issue is *whether* a certain cost or a certain kind of cost is proper to be passed on to the consumers as a matter of regulatory policy. The reasonableness of management in incurring the cost is not at issue. It is this type of decisions which must be made by a regulatory body and which cannot be made by management.[51]

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[51] As an example, on November 1, 1973, the Commission issued its Opinion No. 672 in Texas Eastern Transmission Corporation, Docket Nos. RP70-29, et al., disallowing costs associated with some $9,000,000 of advance payments. The pipeline had made the advance payments in the exploration and development of gas reserves in the Sable Island area of offshore Nova Scotia. The Commission disallowed these because, inter alia, the pipeline had "failed to show that the advance payment arrangement is reasonable in view of the extended period of time during which the rate-payers would be required to pay return and taxes . . . before sufficient gas reserves could be found to make the venture feasible * * *" (pp. 5-6). It also expressed doubt that the Canadian gas could ever benefit U.S. consumers (p. 9).

The Commission has also proscribed certain *types* of contract provisions where there was no question that they met the standard of managerial prudence and discretion but there were other serious public interest objections, e.g., "indefinite" escalation provisions [see Order No. 232A, Docket No. R-153, 25 FPC 609 (1961); Order No. 242, Docket No. R-203, 27

While the large producer or pipeline can negotiate the best possible price with a small producer under market conditions existing at the time, there is no way that it can go behind that price to examine the small producer's costs or other factors which might be relevant and material in a just and reasonable rate determination. Such a purchaser has no power of discovery or other regulatory tools at its disposal even if it had the expertise. Such an impossible burden, the burden of regulating, cannot and therefore may not lawfully be shifted to the large producers and pipelines. The orders accordingly must fall.

IV.

THE ORDERS DISCRIMINATE UNFAIRLY AGAINST LARGE PRODUCERS

The Orders under review have been, for some unstated reason, carefully contrived to squeeze large producers. The beneficiaries are the small producers and pipelines as we shall show.

A. The Orders unfairly discriminate against large producers in favor of small producers.

1. **Large producer plant operators.** The Orders effectively shift dollars from plant operators to small producers. Large producer plant owners will be forced to pay more for some small producer gas than they can collect for reselling it. Orders 428 and 428-B restore full effect to numerous contracts between plant operators, like Phillips, and small producers, but they do not permit the plant operators to pass on such increases unless their resale contracts permit such increases (App. 150). Hence, the large producer plant operator must now absorb increased costs for gas purchased from small producers.

FPC 339 (1962), affirmed, Federal Power Commission v. Texaco Inc., 377 U.S. 33 (1964)] and "excessive" take-or-pay provisions [see El Paso Natural Gas Company, Opinion No. 390, 29 FPC 1175, 1185 (1963); Michigan Wisconsin Pipe Line Company, Opinion No. 353, 27 FPC 449, 454-57, 463 (1962); Panhandle Eastern Pipe Line Company, Opinion No. 350, 27 FPC 35, 46, 51 (1962)].

Plant operators like Phillips object to the Orders because they fail to recognize that the industry has been built up under a system where *all* jurisdictional wellhead sales of gas, and jurisdictional sales of residue gas at plant outlets have been regulated by the Commission. As a result of the first *Phillips* decision the processing industry was subjected to regulation under the Act insofar as its residue gas prices were concerned, and resale contracts with pipelines were thereafter negotiated within that regulatory framework. More recently, under the area rate method, the Commission applied area ceilings to sales at the plant outlet and to gas acquired by plant operators at the wellhead, including small producer gas.

Processing plant operations have accordingly been built upon a *spread* or differential between aggregate gas costs and aggregate residue gas revenues. Now, however, the Commission has decided to deregulate the spread insofar as small producer wellhead rates are concerned. *Half* of the regulatory framework is suddenly blown away with the result that small producers are enriched at the expense of the large producer plant operators. In the name of administrative convenience, the Commission has shifted substantial dollars from one party to another without any finding that the small producers need such excess revenues generated from their rates and without any evidence to support such a finding if one was intended. The commission has seriously distorted the economic balance and competitive factors within the industry without visible recognition of its statutory obligation to maintain a healthy industry structure.[52]

The Commission, claiming that the *Sierra* doctrine[53] requires adherence to the contract price, rejected Phillips' request that a plant operator be allowed to pass through the customary differential between its gas costs and the resale price of residue

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[52]See Southern Louisiana Area Rate Cases, 428 F.2d 407, 442 (5th Cir. 1970) certiorari denied 400 U.S. 950.

[53]Federal Power Commission v. Sierra Pacific Power Company, 350 U.S. 348 (1956).

gas regardless of the price specified in the resale contract. We contend that the Commission erroneously construed *Sierra* and that its refusal to grant the relief requested was arbitrary, capricious and unduly discriminatory.

Here, where the aggrievement is caused by Commission action, it is error for the Commission to relay on *Sierra* in denying relief to plant operators. In *Sierra,* the Commission had allowed a regulated company to increase its rate to Sierra unilaterally although the contract provided for the old, lower rate. The Court held that neither the unilateral filing nor the Commission's finding that the new rate was not unlawful was effective to change the contract with Sierra. 350 U.S. at 353. Here there is no unilateral increase being proposed by the plant operators but, rather, an attempt to recoup cost increases resulting from the Commission's abrupt reversal of established regulatory policy.

The Commission has the power to grant the relief requested and it should have done so here. *Sierra* leaves no doubt as to that power:

> "* * * The Commission has undoubted power . . . to prescribe a change in contract rates whenever it determines such rates to be unlawful. * * * [T]he Commission's order here, if based on the necessary findings, could have been effective to prescribe the proposed rate as the rate to be in effect prospectively from the date of the order, June 17, 1954. * * *
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> * * * * *
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> "The condition precedent to the Commission's exercise of its power . . . is a finding that the existing rate is 'unjust, unreasonable, unduly discriminatory or preferential.' * * *" (350 U.S. at 353).

We contend that it was unduly discriminatory and preferential, arbitrary, capricious, and an abuse of administrative discretion for the Commission to adopt a policy which shifts costs to plant operators but refuses to allow a pass on of those costs. The extreme unfairness of the Commission's action can be seen in the context of minimum rates: in its area rate

method of fixing just and reasonable rates the Commission, relying on *Sierra*, has fixed just and reasonable minimum rates and declared that such minimums may be charged by the seller even though he voluntarily agreed to a lower contract rate.[54] In the orders here, the Commission expressly provided that small producers could charge the "minimum rate authorized by the Commission for any area" (App. 144 n. 5)–*i.e.*, the small producer may exceed his contract price. But the plant operator may not exceed *its* resale contract price to pass along the Commission-imposed increase in costs.

We submit that if the impact of small producer sales is so insignificant that considerations of administrative convenience warrant the exemption of such sales from regulation, then the public should bear the "insignificant" cost increases. If, on the other hand, small producer sales are significant, affecting the rates "of millions of American consumers" as the Commission found in *Permian, supra,* then they should not be exempted. But in niether case is the Commission justified in practicing the unlawful discrimination which shifts dollars from the plant operators' pockets into the pockets of small producers without findings or evidence to support such a result. We contend that the Act does not permit such basic disruption of the regulated industry without the most compelling evidence of the absolute necessity for such disruption.

2. **Large producers selling gas at the wellhead.** Large producers selling gas at the wellhead are unfairly discriminated

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[54]34 FPC at 231-32, affirmed 390 U.S. at 821. Of course, in those cases the Commission was also fixing resale rates of plant operators, and it had a complete evidentiary record and findings.

against in favor of small producers. Small producer sales are "authorized" under the blanket certificate provided for in Order No. 428. No administrative delay is involved once the small producer receives his blanket certificate; hence new sales can be commenced immediately. Large producers, on the other hand, must obtain a separate certificate for each new sale, and there are weeks of delay involved in preparing and filing applications and obtaining authorization. The unfairness of this emerges sharply in the situation where both the small producer and large producer own interests in the same gas reservoir. The small producer can commence selling gas immediately, but the large producer is forced to suffer drainage while awaiting certificate authorization.

The problem is not regulatory delay, *per se*, but delay to some producers who are forced to comply with the Act, and no delay to other (small) producers who are not required to comply. Delay to some because the Regulations implement the Act, and no delay to others because the Regulations exempt that class from the Act's requirements. We say that the Commission may not thus discriminate and force large producers to suffer the loss of their property without compensation.

B. The Orders unfairly discriminate against large producers in favor of pipelines.

1. **Rate increases and refunds.** Pipelines are allowed by Orders 428 and 428-B to pass through without any refund obligation the increased costs of small producer purchases under contracts dated before March 18, 1971. All small producer increases in rates above the just and reasonable area ceiling rates will be passed on by the pipelines without any Commission scrutiny of the appropriateness of the rates.

For the large producers, it is a different story. We have already noted how large producer plant operators are limited in their tracking rights to rates specified in their contracts. Additionally, the generality of the wording of the orders would allow the Commission to suspend a producer plant operator's contractually permissible increase and allow its collection subject to refund under the amorphous standards of its regulation:

"* * * Any such [large producer plant operator] rate filing shall be accepted if the price differential between the purchase and resale prices does not exceed the prevailing price differential in the area, and if the small producer prices for new gas are not unreasonably high, considering appropriate comparisons with highest contract prices for sales by large producers or the prevailing market prices for interstate sales in the same producing area." (App. 150).

This price differential test for producer plant operators applies to both old and new contracts.

There is no basis for thus imposing on large producers the jeopardy with respect to old contracts which was specifically lifted from pipelines. And as usual, the Commission has offered no such basis. The orders must therefore be set aside.

2. **Competition for new gas.** The orders also discriminate in favor of pipelines and against large producer plant operators in the competition for new gas. Both large producer plant operators and pipelines will be competing for new small producer gas. It often happens that a pipeline buys unprocessed gas at the wellhead and will compete with a producer-plant for the very same small producer's gas.

Under the Commission's new regulations, pipelines will have substantial competitive advantages. First, pipelines will be able to contract for this new gas at any price: they will be able to collect such rates, perhaps subject to refund, but always with the opportunity to show that the rates are not "unreasonably high considering appropriate comparisons with highest contract prices for sales by large producers or the prevailing market price for intrastate sales in the same producing area." (App. 142). Furthermore, even if a given price should not come within this framework, it could still be offered by a pipeline if the volumes were substantial enough, or if the pipeline were gas hungry enough, so that the pipeline could risk suspension and possible refund.

Second, the orders discourage percentage-of-the-proceeds sales to large producers. Such sales typically provide for payment by the processing plant to the wellhead seller (*e.g.*, the small producer) of a percentage of revenues derived from the resale of gas stream components. No small producer is going to sell to a large producer who is locked into a resale contract price when it could get the higher intrastate price from an interstate pipeline.

Further, pipelines have the ability to connect new supplies immediately under budget-type certificates. Large producer plant operators, on the other hand, are effectively precluded from connecting new supplies to be sold under new resale contracts until they have filed a certificate application (App. 253). In light of the highly competitive nature of the industry, it was unduly discriminatory and an abuse of discretion for the Commission to deny plant operators the same freedom from administrative delay which is enjoyed by pieplines.

For all of the above reasons the Orders unfairly discriminate against large producers. In some cases the balance is in favor of the small producers, in other cases in favor of the pipelines: but always against the large producer. This is not permitted by Section 4(a) of the Act which forbids the Commission itself as well as the companies regulated by it to "... make or grant any undue preference or advantages to any person or subject any person to any undue prejudice or disadvantage. ..."

CONCLUSION

For the foregoing reasons, Phillips submits that the opinion and judgement of the Court of Appeals should be affirmed.

Respectfully submitted,

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